FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Hemsö Fastighets AB at 'A+'; Outlook Stable

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Fitch Ratings - Frankfurt am Main - 30 Mar 2022: Fitch Ratings has affirmed Hemsö Fastighets AB's (Hemsö) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'A+' with Stable Outlooks. A full list of rating actions is detailed below.

The affirmation reflects Fitch's unchanged expectation that Hemsö's leverage should continue declining towards 14x by the end of our forecast period of 2022-2026 (2021: 16.2x), a level consistent with a 'bbb+' Standalone Credit Profile (SCP). This expected improvement is driven by the strengthening of Hemsö's EBITDA margin and a slowdown in its capex programme. Its high leverage is offset by a strong liquidity position and its reliance on long-term lease contracts with solid public-sector counterparties in northern Europe.

Fitch rates Hemsö under its Revenue-Supported Rating Criteria and applies a three-notch uplift to Hemsö's 'bbb+' SCP to arrive at the 'A+' Long-Term IDR, reflecting its strong link to its owner, AP3, one out of five Swedish pension funds. In applying its Government-Related Entities (GRE) Criteria, Fitch looks past AP3 and directly links Hemsö to Sweden (AAA/Stable/F1+), via AP3's role as a pension fund on behalf of the government for the Swedish population.

Hemsö Treasury OYJ's bond rating of 'A+' is based on the unconditional and irrevocable guarantee by Hemsö. Hemsö Treasury OYJ is a fully owned subsidiary of Hemsö and changes to Hemsö's Long-Term IDR will be reflected in the senior unsecured rating on the bond, issued out of Hemsö's EUR4 billion euro medium-term note (EMTN) programme.

KEY RATING DRIVERS

Status, Ownership and Control: 'Strong'

Hemsö is one of the largest property providers focused on social infrastructure in Sweden and is 85% owned by AP3. AP3 has a call option for the remaining 15% owned by Sagax, a Swedish private for-profit property company. Hemsö is a commercial law company exposed to bankruptcy law and there is no automatic liability transfer of its assets and liabilities to its owner in the event of default. The 'Strong' assessment is driven by the tight control and monitoring by AP3, which appoints its board, and sets and approves Hemsö's long-term business strategy.

The members of AP3's board are appointed by the government and are required to report at least annually to the government, which reports to parliament.

AP3 is supervised by the Swedish Financial Supervisory Authority and in Fitch's view, the Swedish government has significant control over the fund via the appointed board members. AP3 has access to liquidity at the National Debt Office, which manages Sweden's debt. Fitch views AP3 as ultimately strongly linked to the state, also considering the important public mission the fund provides.

Support Track Record: 'Moderate'

AP3 views Hemsö as a strategic investment, which pays dividends to its owner (2021: SEK905 million). Hemsö is not reliant on operational grants and subsidies. However, we see tangible signs of support granted by AP3 in the form of a multi-annual committed credit facility of SEK5 billion, strengthening Hemsö's liquidity profile. This is based on a subscription agreement and AP3 is committed to buy up to SEK5 billion of commercial paper (CP) out of Hemsö's SEK8 billion commercial paper (CP) programme, should Hemsö face difficulties placing it in the capital markets.

Direct financial support has been granted through capital injections to support Hemsö's business growth, reflected in SEK3 billion contributions in 2019-2021. According to Hemsö, additional capital is available if needed. There are no restrictions on support. AP3 may buy Hemsö's bonds or grant loans to it but is not allowed to guarantee Hemsö's debt. Our 'Moderate' assessment reflects our interpretation of these capital injections as investments in Hemsö's business development and not as tangible signs of support. It also factors in the liberalised market environment and Hemsö's international footprint, which would likely limit the flexibility of the government to provide support in certain scenarios (notably due to restrictions such as state aid regulation).

Socio-Political Implications of Default. 'Moderate'

Hemsö operates in an important and growing market, driven by Sweden's estimated population growth and the government's obligation to provide sufficient social infrastructure. In Fitch's view, a default of Hemsö would be politically very sensitive and create a large loss for AP3, while Hemsö's activities could be gradually taken over by other private or public operators. Further, we deem a financial default would have limited impact on its operations.

Financial Implications of Default: 'Moderate'

Hemsö benefits from a strong and sustained presence in the financial markets as a frequent issuer of local- and foreign-currency bonds and loans, having successfully established a EUR4 billion EMTN programme, a SEK12 billion MTN programme and a SEK8 billion CP programme. Given its commercial law status and non-policy-role, Hemsö's links to the public sector are based on AP3's 85% ownership.

We do not view Hemsö as a government proxy-funding vehicle and its debt is marginal in the context of the central government's debt (AP3 is debt-free). A default of Hemsö would have only a moderate impact on the availability and cost of funding for the public sector and other Swedish GREs.

Standalone Credit Profile

Fitch rates Hemsö under its Revenue-Supported Rating Criteria and takes into account factors such as revenue defensibility, operating risk and financial profile. Its SCP factors in its high leverage, which we expect to decline towards 14x in the medium term. The high leverage is somewhat offset by Hemsö's strong liquidity position, amounting to SEK13.2 billion at end-2021 (including credit facilities of SEK12.5 billion, of which a high proportion is committed over several years and SEK0.7 billion of cash).

Revenue Defensibility: 'Stronger'

Fitch assesses Hemsö's demand characteristics as 'Stronger' based on high demand for social infrastructure in Sweden. Its property portfolio consists of nursing homes (contributing 38% to its property value), educational buildings (35%), healthcare properties (15%) and properties belonging to the justice system (11%), such as police stations. Given its core market of nursing homes and education, together accounting for

74% of its properties, Hemsö can rely on strong demand from Sweden's expected population growth of 10% in 2017-2029 and growth of 58% for people over 80 years old. In Finland and Germany, where Hemsö also has properties, population and the share of elderly people are also expected to increase.

Hemsö has a well-established relationship with the public sector, which contributes positively to its demand. This is reflected in a large and increasing share of its rental revenue coming from public tenants (2021: 63%) with long-term leases, and highly rated counterparties. In 2021, 94% of rental income was directly or indirectly backed by public tenants (tax-financed). This supports revenue sustainability and strengthens its business profile.

At present, Hemsö has exposure to significant private rental income, but this is mitigated by undersupply in the market and the obligation of Swedish municipalities to provide social infrastructure services. If a private provider stops operating the public sector would likely step in to meet this obligation. As Hemsö has identified social infrastructure as a growth area, driven by population growth and undersupply, we assume the share of rents stemming from private tenants will continue to decline.

Hemsö is actively divesting its non-core properties, which should keep its vacancy rate below 2%. Hemsö increased its average lease duration to 9.6 years in 2021 from eight years in 2016, supporting cash flow predictability.

We have assumed moderate stress in our rating case, and the pandemic to have a limited impact on Hemsö's financial results. We expect public-sector tenants (including municipalities, counties and the central government in Sweden), which generated 63% of revenue in 2021, to maintain their contractual agreements.

We believe the overall effect of the pandemic will not affect our EBITDA and leverage assumptions in our rating case, based on Hemsö's 2021 results, long-term leases, high occupancy rate of 97.9% in 4Q21, low vacancy rate of below 2% in 2021 and high demand for its properties.

Fitch views the pricing characteristics of Hemsö's properties as 'Midrange', as we believe it will be able to collect sufficient revenue to cover at least inflationary increases. Based on the last 10 years of performance, property income has consistently covered property costs by over 3x, and specifically 4.1x in 2021. To ensure stable inflation-adjusted income, Hemsö aims to expand its long-term lease agreements. The average lease was 9.6 years at end-2021 and lease agreements for new construction are 15-25 years. The agreements include annual rent adjustments to reflect increases in the consumer price index.

Operating Risk: 'Stronger'

Fitch assesses operating risk - comprising operating cost and resource management - as 'Stronger'. In Fitch's view, Hemsö's operating costs are well identified and not affected by significant volatility. They have consecutively increased over the past 10 years, but growth remained below that of its property income.

Hemsö's EBITDA increased to SEK2,580 million in 2021 from SEK899 million in 2010. We expect the trend to continue, reflecting improving cash flows, inflation-linked contractual agreements and no meaningful increase in the share of staff costs in operating spending. The increase in Hemsö's expenditure stems from its development and corresponding maintenance costs, which are scheduled to grow more slowly than operating revenue from new projects.

Hemsö aims for further growth through investments on average at SEK3.9 billion in 2022-2026, but we assume it has flexibility in timing of major costs and is able to postpone scheduled investments in case of need.

We assume vacancy risk is not material, considering high demand for properties managed by Hemsö. Property costs are mainly derived from operating costs related to heating, electricity, maintenance, property tax and leasehold fees. We assume this risk is mitigated by Hemsö's expertise and prudent management and its improving building standards.

Financial Profile: 'Midrange'

We expect Hemsö's net adjusted debt to increase to SEK54.5 billion by 2026 (2021: SEK41.8 billion), driven by cumulative investments of SEK19.2 billion in 2022-2026. Some SEK5.4 billion may be spent in 2022 and SEK4.8 billion in 2023. Investments will decline to below SEK4 billion in 2024-2026.

As the investment plan includes projects that contribute to Hemsö's cash flow in 2022-2026, we expect EBITDA to increase to SEK3.9 billion in 2026 from SEK2.6 billion in 2021 and for Fitch-calculated net debt/EBITDA to decline to 14x from 16.2x in the same period. The positive development should be considered in a scenario of ongoing debt-funded investments. If Hemsö's business expansion slows we would expect the leverage ratio to show an even stronger decelerating trend.

Hemsö's financial profile is supported by its sound liquidity position of SEK687 million at end-2021, ample access to liquidity and available credit facilities of SEK12.5 billion at end-2021, which together covered Hemsö's debt maturing in 2021 by 1.7x.

Additional Risk Factors Assessment

Fitch does not see any additional risk that could negatively affect Hemsö's SCP. Fitch views Hemsö's financial management as prudent, particularly given the regular update of its multi-year financial plan and its fully hedged foreign-exchange and interest-rate risks.

DERIVATION SUMMARY

Hems's SCP of 'bbb+' is driven by its high leverage, which is mitigated by its sound liquidity position and its stable cash-flows based on long-term lease agreements with tenants from the public sector. The combination of the 'bbb+' SCP and our bottom-up approach with a three-notch uplift leads to a Long-Term IDR of 'A+'.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

An upgrade of Hemsö's IDRs could result from a strengthening of its SCP, based on net-debt-to-EBITDA declining to 12x. An upgrade could also result from our assessment of improved support under our GRE Criteria.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

A downgrade of the IDRs could result from a weaker assessment of Hemsö's SCP, with net-debt-to-EBITDA sustainably above 15x. A downgrade could also result from our assessment of diminished strength of linkage or incentive to support under our GRE Criteria.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Total adjusted debt reported at end-2021 amounted to SEK42.5 billion and Hemsö's debt structure is sound. At end-2021, almost 100% of the debt was fixed-rate, the average maturity was 6.8 years and debt amortisation schedule is showing only some concentration in 2026. During 2022, Hemsö will have to refinance 19% of its adjusted debt at end-2021. This is mitigated by its well-established access to capital markets as well as its comfortable liquidity position. At end-2021, Hemsö had SEK13.2 billion of available liquidity (SEK687 million of unrestricted cash and SEK12.5 billion of committed credit facilities), covering its maturing debt by 1.7x in 2021.

ISSUER PROFILE

Hemsö is one of the largest property providers focused on social infrastructure including nursing homes and educational, health care and judicial properties. Hemsö operates in Sweden (67% of its property portfolio), Finland (16%) and Germany (17%).

SUMMARY OF FINANCIAL ADJUSTMENTS

Fitch has deducted the value changes in the revenue item "profit/loss from participations in associated companies" and considered it as non-cash operating revenue, while Hemsö deems this as operating income.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY / DEBT	RATING		PRIOR
Hemso Fastighets AB	LT IDR Affirmed	A+ Rating Outlook Stable	A+ Rating Outlook Stable

	ST IDR F1+ Affirmed	F1+
	LC LT IDR A+ Rating Outlook Stable Affirmed	A+ Rating Outlook Stable
	LC ST IDR F1+ Affirmed	F1+
Hemso Treasury OYJ		
senior unsecured	LT A+ Affirmed	A+

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APPLICABLE CRITERIA

Government-Related Entities Rating Criteria (pub. 30 Sep 2020)

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 01 Sep 2021) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Hemso Fastighets AB	EU Issued, UK Endorsed
Hemso Treasury OYJ	EU Issued, UK Endorsed

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